HSBC PREMIER

Global Investment Perspective

December 2008

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Euro Weakening outlook and ECB rate cut unfavourable for currency.

Sterling Risk policy initiatives could steer currency to the downside.

Japanese Yen Strong technical factors contrast weak economic outlook.

Canadian Dollar US dollar strength plus sliding commodities and equities negative for the loonie.

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Canada Attractive valuations, but credit crisis and weaker commodities depress markets.

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US Supported by flight to safety, but oversupply clouds medium-term outlook.

Eurozone Safety feature a big plus, but likely increase in supply a major negative.

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Emerging Markets Not immune from developed world slowdown.

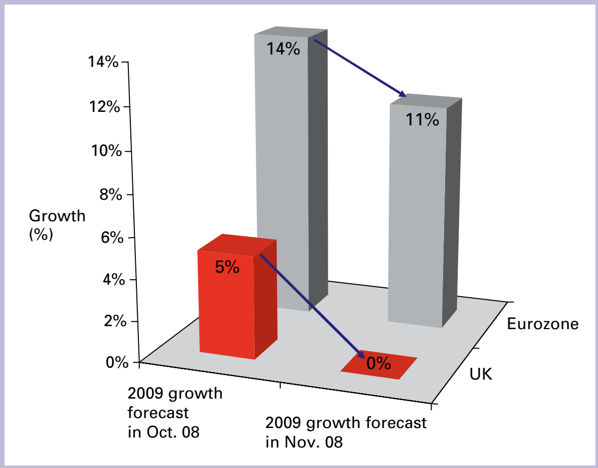
Investment Grade Most appealing valuations ever, but default risk rising.

High Yield Poor sentiment and risks to growth continue to weigh on the asset class.

The global economy continued to weaken throughout November, as investors kept selling. However, a late-November rally meant that the slide was not as severe as initially feared. The US fell 8%, the eurozone was down 6%, Japan slipped 4%, Canada was 5% lower, and emerging market equities fell 8%.

During the month, US unemployment, retail sales and business and consumer confidence continued to deteriorate. Consensus forecasts for global economic growth are now uniformly weaker for 2009. Also, earnings growth expectations for 2009 continue to decline; in November these expectations fell from 20% to 13% in the US. Projected 2009 earnings growth in Europe has fallen more substantially (see the chart below).

2009 corporate earnings growth forecasts



Sources:
HSBC Global Asset Management,
Thomson Datastream, Bloomberg, Barclays
(November 2008)

In light of tight credit markets, weak inflation-adjusted income and slowing vehicle sales, US automakers appealed to Congress for an immediate US$34 billion bailout package to avoid bankruptcy. Congress rejected the request and asked the automobile chiefs to return with detailed restructuring plans. In early December, the federal government indicated it was prepared to give the big three automakers US$15 billion in short-term funds.

There was also a surprising reversal in the Troubled Asset Relief Program (TARP) as Henry Paulson, the US Treasury Secretary, shifted from buying toxic assets to focusing on recapitalizing financial companies. Even though credit markets have eased somewhat since these capital injections, the change in policy provoked additional uncertainty and negativity among investors. That said, the US and other governments worldwide are likely to continue their efforts to stimulate their economies by providing liquidity injections and various fiscal stimuli.

Given continued economic weakness, most markets are pricing in interest rate cuts, with a possible 50 basis point (or half percentage point) cut by the middle of next year in the US. Falling energy prices, and hence inflation, and continued market turmoil should also give the eurozone and UK authorities room to cut rates further. They are expected to fall to 2% and 1.25%, respectively, within the next 12 months.

Although markets appear to remain fraught with uncertainty heading into 2009, we see falling inflation, increased government spending, low interest rates and loosening credit conditions as positive developments. Downward revisions to earnings growth also suggest that a lot of the bad news has been reflected in equity prices. The long-term valuation case for equities, and especially corporate debt, has become increasingly compelling. Given the moves in risky assets and tight liquidity, we do not think the time is right to increase exposure to risky assets. Potential catalysts we will look for as signs to increase the portfolio risk include a sharp reduction in volatility, stabilization of the economy (especially in the US), a sustained improvement in credit conditions and a zero interest rate environment in the context of positive inflation.

Currency

US Dollar

Fairly valued, but likely to be volatile

- In November, the US dollar gained 0.3% against the euro, rose 4.5% versus the British pound, gained 3.5% over the Canadian dollar and lost 3% against the yen.
- The rebound was driven more by sentiment than fundamentals.
- In terms of valuations, the US dollar is at fair value. Given the current weakening economic picture across all developed countries, risks are balanced.
- In the very short term, currencies can move in a sharp and often short-lived fashion due to short-term capital flow movements.
- Given the high volatility, we reiterate our neutral view.

Euro

Weakening outlook and ECB rate cut unfavourable for currency

- In November, the euro surged against the pound, gaining 4.2%, but lost against the US dollar by 0.3% and the yen by 3.3%.
- Weakness in the euro was caused by more pessimism about economic growth (e.g., the downward revision in consensus 2009 GDP growth to -0.2%) and the cut in interest rates by the European Central Bank.
- With rates falling in the eurozone, the interest rate differential is becoming less of a driver for the euro–US dollar exchange rate.
- As the US and eurozone face similar macroeconomic problems, risks are balanced. Hence, we maintain a neutral position.
- But if the US recovers before the eurozone, there could be an outflow from eurozone equities to US equities, with a negative impact on the euro.

Sterling

Risk policy initiatives could steer currency to the downside

- November was another difficult month for the pound sterling. The currency lost heavily against the dollar (down 4.5%), the yen (down 7.2%) and the euro (down 4.2%).
- These losses were mainly due to weakness in the housing market and economy.
- At -0.9%, the UK now has the lowest consensus 2009 growth forecast among developed markets.
- We expect a 75 basis point cut in rates by mid-2009 to support growth. The Bank of England has indicated it is willing to allow the currency and deficit to adjust as much as needed.
- In the short term, there is risk of further depreciation of the pound. But from a valuation perspective, the currency is broadly at fair value relative to the US dollar.

Japanese Yen

Strong technical factors contrast weak economic outlook

- The yen gained against all the major currencies again in November. It rose 3% against the US dollar, 7.2% relative to the pound and 3.3% versus the euro.
- Risk aversion and unwinding of carry trades moved in favour of the yen again. (A carry trade involves borrowing in a low-interest currency, in this case the yen, and investing in a higher-interest currency.)
- The yen is now broadly at fair value relative to the US dollar.
- The macroeconomic picture continues to be weak, with the Japanese economy technically in recession after two consecutive quarters of negative GDP growth.
- With the given uncertainties, we maintain our neutral view on the currency on a six- to 12-month period.

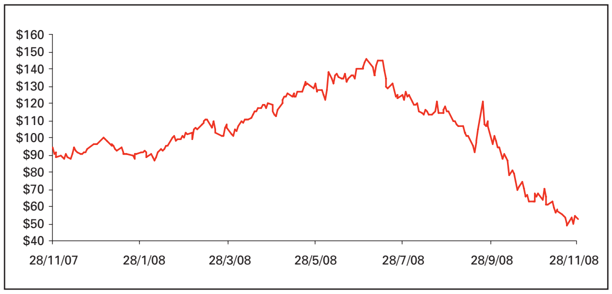
Canadian Dollar

US dollar strength plus sliding commodities and equities negative for the loonie

- The loonie began November at US$0.84 before slipping to end the month at US$0.81 — a 3.5% decline. Toward mid-November the loonie was worth US$0.80.
- The drop was driven by widespread market moves into US dollars and sharp declines in Canadian equities and commodity prices.
- Continuing the trend seen in October, these moves left the loonie in slightly oversold territory.
- However, on a long-term fundamental basis, the loonie is close to fair value versus the US dollar.

Commodity

Oil Price (US$) — 1 year



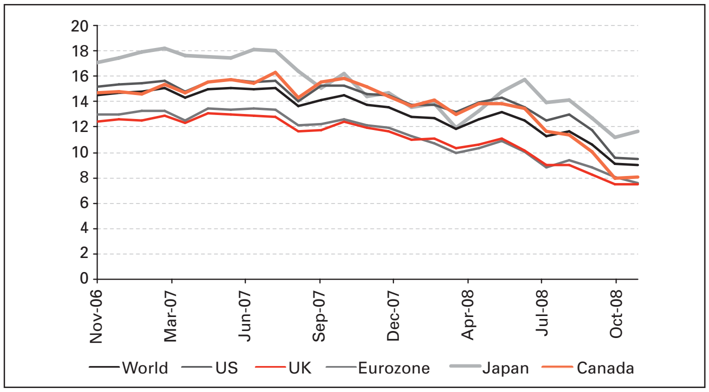
Sources: HSBC Global Asset Management, Thomson Datastream, Bloomberg, Barclays (November 2008)

Oil

Geopolitical tension to support prices, but downside risks remain

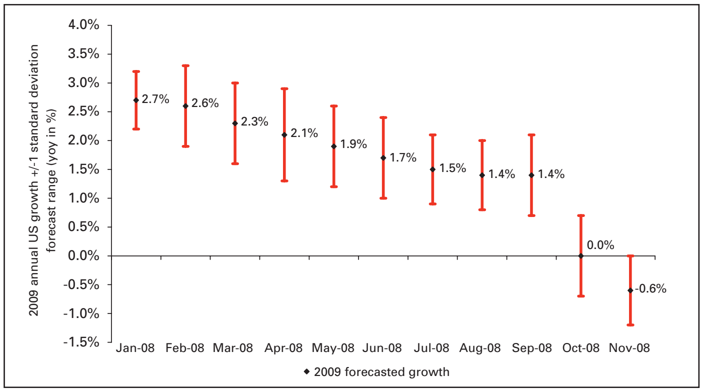
- US dollar strength and grave economic growth concerns caused the oil price to fall another 20% in November to US$54, down about 63% from its July peak of US$145. By early December it was trading in the low US$40 per barrel range.
- Adding to oversupply concerns are fears that OPEC may not significantly cut production to support oil prices.
- And in the US, Americans are driving less. Vehicle miles travelled dropped 4.4% in September, according to the Department of Transportation.
- However, geopolitical tension should provide some support for oil prices. We expect oil to trade in the US$40-60 range over the next year.

Market



Price-to-earnings ratio based on 12-month forward earnings

Sources: HSBC Global Asset Management, Thomson Datastream, Bloomberg, Barclays (November 2008)



2009 growth forecast collapses

Sources: HSBC Global Asset Management, Thomson Datastream, Bloomberg, Barclays (November 2008)

US

Attractive yields, but risks to growth and earnings call for caution

- The S&P 500 fell 8% in November, on concerns over earnings forecast declines, weak economic growth and a change to the US TARP program that saw a shift from buying toxic assets to focusing on recapitalizing financial companies.
- US stocks are trading at about nine times their price-to-earnings ratio, and the current overall equity earnings yield is attractive. But the economic growth risks are still high, and ongoing bank asset valuation losses and financial turmoil may continue to hurt lending activities.
- Earnings revisions, on the other hand, have come down and are more in line with a weak growth environment.
- On a positive note, inflation risks have come down somewhat.
- Overall, we reiterate our cautious message on equities relative to cash. We expect US equities to perform in line with their global peers.

Europe

Substantial negatives priced in, yet risks remain to the downside

- UK and eurozone equities fell 2% and 6% respectively in November as a result of ongoing economic stress and growth uncertainties.
- The year-to-date decline of equities in Europe has been steeper than in the US (-49% versus -39%).
- 2009 earnings growth estimates were halved during November to more reasonable levels.
- At eight times forward price to earnings, European equities are attractive. But this is counterbalanced by the high economic growth risks.
- Thus, we reinforce our defensive message of favouring cash in the short term. We believe European equities will perform in line with their peers.

Japan

High valuation and weak growth outlook

- Equities on Japan's TOPIX index fell 4% in November as the country braced itself for a prolonged slowdown, as the destinations for much of its exports (such as the US and elsewhere) see their economies weaken.
- Given the sharp decline in earnings projections, the forward price-to-earnings multiple increased to 12 times, a move that diverges from other developed countries.
- We have a prolonged slowdown as our base scenario. Persistent economic difficulties in developed markets may continue to hurt Japan's growth.
- With the Bank of Japan's rate already at a low 0.3%, monetary easing may do little to encourage further growth.
- Given the valuation and risk balance, we remain neutral on Japan's equities versus equities in other regions.

Asia ex-Japan

Attractive valuations, but growth picture still weak

- Asia ex-Japan equities fell 6% in November as economic uncertainties in developed markets added to growth concerns in the region.
- The price-to-earnings multiples have fallen to low levels of 10, nine and eight times in Hong Kong, India and China respectively.
- Despite seemingly high economic growth numbers, central banks in Asia are cutting their interest rates aggressively in anticipation of slower growth ahead.
- As a result, even with the steep price declines, the increased uncertainty surrounding economic trends leads us to reinforce a defensive message on equities versus cash in the region.

Emerging Markets

Price multiples attractive, but substantial risks exist

- Emerging market equities fell 8% during November as economic data continued to weaken broadly across these markets and growth forecasts were revised down.
- The price-to-earnings multiples, at nine times in emerging Asia and seven times in Latin America, are generally attractive. But risks remain from continued slowing in economic activity.
- Therefore, despite attractive valuations we continue to favour cash for the short term given the growth risks. We expect emerging market equities to perform in line with developed markets.

Canada

Attractive valuations, but credit crisis and weaker commodities depress markets

- Valuations in the Canadian market continued to become more attractive. The forward price-to-earnings multiple fell to about nine times earnings — a level not seen since the 1970s.
- These attractive valuations are counterbalanced to some extent by the ongoing credit crisis and sliding commodity prices, which will likely continue to mean more volatility in the coming quarters. Faltering exports to key markets like the US are also a negative.
- Sliding oil prices continued to be a challenge for the energy sector. But the telecom sector was the hardest hit as the BCE deal began to unravel after it failed a key solvency test.
- We maintain our cautious view of Canadian equities relative to cash. We expect Canadian equities to perform roughly in line with global markets.

Interest rate/Fixed income

US

Supported by flight to safety, but oversupply clouds medium-term outlook

- November was another good month for US Treasuries because of the ongoing flight to safety, a moderating inflation outlook and expectations of further rate cuts.
- A representative portfolio of US government bonds returned 5.4% in November.
- Given the extremely low yields, the asset class remains unattractive from a valuation point of view.
- For the medium term, the outlook for the asset class is clouded by the increased issuance of debt to support economic growth. This increase in supply is likely to be a negative for the price of Treasuries, all things being equal.
- Yet in the short term, the focus on safety and liquidity continues to support US government bonds and leads us to maintain our neutral stance.

Eurozone

Safety feature a big plus, but likely increase in supply a major negative

- Easing inflation, expectations of further rate cuts and low risk appetite contributed to another strong month for eurozone government bonds.
- The asset class gained 3.9% in November, while yields plunged for all maturities.
- Similar to US Treasuries, eurozone government bonds are not appealing from a valuation point of view.
- And also similar to US Treasuries, increased debt issuance and unappealing valuations weigh negatively on the medium-term outlook for the asset class.
- Despite the medium-term concerns, the potential for more rate cuts and the flight to safety provide near-term support for the asset class, thus we suggest a neutral stance in the short term.

Canada

Corporate bond spreads continue to suggest opportunity

- The Bank of Canada had no scheduled interest rate meetings in November. But on December 9, as expected, the Bank cut overnight rates by 75 basis points, bringing them to 1.5% — their lowest level since 1958.
- To justify its decision, the Bank highlighted three key risks to Canada's economy: a weak US trading partner, falling commodity prices and little improvement in credit conditions.
- The early December political crisis may result in more aggressive government stimulus, which would be beneficial for the economy.
- Corporate bond spreads over government bonds remained at all-time highs, which suggests opportunities are available in select corporate bonds. Government bond yields remain lower than current conditions appear to warrant.
- However, risk aversion remains so high that it is unlikely government bond yields will increase in the short term, and so we maintain our neutral stance.

Emerging Markets

Not immune from developed world slowdown

- Emerging markets have increasingly slowed, and government intervention has been necessary to stabilize some major emerging markets.
- While the weak performance has increased the spread for emerging market debt, spreads are not at their peak levels relative to the previous crises.
- So given continued growth risks in the emerging markets, together with their yields relative to yields in other risky fixed income assets, we are negative on this asset class.

Investment Grade

Most appealing valuations ever, but default risk rising

- Despite the increase in yield spreads over government bonds, the asset class produced a positive performance during the month thanks to lower LIBOR rates. (LIBOR is the London interbank offer rate, which is what banks charge each other for loans.)
- On a total return basis, the asset class gained 4% in the US and 2% in the UK.
- Valuations remain at their cheapest level in all key markets, as investors continue to avoid risky assets generally.
- The weak economic outlook and the strains in the financial system are keeping investors risk averse and weigh negatively on the short-term outlook for this asset class.
- Thus, despite appealing valuations, it may still be too early to take a bullish stance on this asset class.

High Yield

Poor sentiment and risks to growth continue to weigh on the asset class

- The asset class performed poorly in November, as spreads for high-yield debt widened dramatically due to strong risk aversion and concerns about the economy.
- Based on a representative basket of global high-yield securities, the asset class lost 8.5% during the month.
- High-yield debt is increasingly attractive from a valuation point of view.
- But the more prolonged and acute the slowdown turns out to be, the higher the risks of default and rating downgrades.
- So in the short term, the weak economic growth picture and heightened risk aversion remain a significant concern that leads us to keep a neutral stance.

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